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RÉSISTANCE ET CONFUSION DANS L'HARMONIZATION DES NORMES COMPTABLES INTERNATIONALES : L'APPROCHE CHINOISE AUX FUSIONS ET ACQUISTIONS

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Résumé : Cette communication se concentre sur le cas du comité de normalisation de comptabilité de la Chine (CASC), qui a agi en 2006 de permettre l'utilisation de la méthode de mise en commun des intérêts pour les fusions dans certaines circonstances. Pourtant, cette méthode a été explicitement interdite par le FASB et l'IASB. On discute dans cet article deux questions principales. La première concerne le contexte culturel et économique du développement économique chinois, ce qui a mené les régulateurs chinois à adopter une approche aux regroupements qui diffère de la norme d'IASB. La deuxième traite du rôle joué par la compréhension de la réalité économique qui sous-tende les regroupements. La complexité de la réorganisation industrielle qui trouve actuellement en Chine mène à la réalisation que quelques regroupements sont des fusions et pas des acquisitions. C'est une observation significative qui soit digne d'une plus grande discussion et considération par les régulateurs des normes comptables internationales.

Mot clés : IASB, regroupement, méthode d'acquisition, méthode de mise en commun, fusion

Abstract: This article focuses on the case of the China Accounting Standards Committee (CASC), which acted in 2006 to require the use of the "pooling of interests method" under certain circumstances when accounting for business combinations. In contrast, the pooling of interests method has been explicitly prohibited by the US Financial Accounting Standard Board (FASB) and the IASB. The paper discusses two principal issues. The first concerns the cultural and economic context of Chinese economic development which led the Chinese standards setters to adopt an approach to accounting for business combinations which differs from the IASB standard. The second deals with the role played by the understanding of the underlying economics of business combinations, which leads in turn to different representations of the combination process. The complexity of accounting for the industrial reorganization that is currently taking place in China has led to the realization that some business combinations are mergers and not acquisitions. This is a significant observation and one which is worthy of greater discussion and consideration by accounting standards setting bodies.

Key words: IASB, business combinations, purchase method, pooling of interest method, merger

1. INTRODUCTION

In this paper we focus on the China Accounting Standards Committee's (CASC) decision, in 2006, to require the use of the "pooling of interests method" of accounting for business combinations under certain circumstances. The paper discusses two distinctive issues regarding the decision of the Chinese accounting standards setters. The first issue concerns the cultural and economic specificity of the accounting standards setting process. The second issue concerns the role played by differential understandings of the economics underlying standards setting. Our central argument is that the technical distinctions between accounting standards issued by different standards setting bodies may be based on different understandings of the underlying economics of transactions, thus leading to different representations of the same economic event. The representations produced by financial reports are derived from a specific context which shapes the regulatory structure. The regulatory structure is then affirmed and supported by standards setters operating within a particular regulatory regime, and is expected to have significant impacts on behaviors of shareholders, management, and auditors (Zhang & Huang 2008). The decision taken by the Chinese standards setters to require the pooling of interests method under certain circumstances provides an empirical example of the tension that exists between accounting's role in serving the needs of global capital markets and its role in facilitating national economic policy. This tension is exemplified by the fair value approach which is primarily intended to serve the needs of global capital markets, while the historical cost approach focuses on operating performance and production which are crucial to national economic development.

The Chinese approach to accounting for business combinations has been directed towards fostering the development of enduring business enterprises which are capable of participating in a global economy. Such firms provide the economic production, employment, and foreign currency revenues that facilitate economic development. Furthermore, these firms enter the international arena by exploiting certain competitive advantages which may be transitory. Thus, entering the international arena is a matter of increased production levels and industrial core competencies rather than maximizing share market values. The Chinese approach emphasizes production and employment, and in this context, accounting regulation becomes primarily concerned with development rather than serving the needs of capital market

participants. This orientation differs from the market facilitating agenda of the international accounting standards setting bodies which place the needs of capital markets at the core of everything.

Interestingly, there has been some resistance to the implementation of international accounting standards in certain countries, thereby leading to a divergence (Ding et al., 2005). For example, the French accounting standards setters rejected the non-amortization of acquisition goodwill in two decisions (No. 2005-9 and 2005-10), issued in November 2005[1]. The Japanese accounting standards setters manifested their dissent to IFRS 3 (Business Combinations) in several comment letters issued in 2001, 2003, and 2005. The Japanese standards setters also permit the pooling of interest method to be used in their national standards, and they require amortization of acquisition goodwill. The Chinese, Japanese and Korean standards setters have joined together in an initiative which will permit the continued use of pooling under certain circumstances (CASC 2006).

In this paper we argue that the actions of the national accounting standards setters which permit or require the pooling of interests method may be based on a different understanding of the underlying economics of business combinations as compared to that of the IASB. In particular, the Chinese standards setters require business combinations between entities under common control to be accounted for using the pooling of interests method. Business combinations of this type are commonplace within the context of industrial reorganization currently taking place in China (Xu and Uddin, 2008). However, business combinations under common control have been specifically excluded from the scope of the IASB's standard on business combinations (IFRS 3). The IASB has recently initiated a project dealing with accounting for business combinations among parties under common control. In the revised version of IFRS3 issued in January 2008 the IASB concluded that "the pooling of interests method provide information superior to that provided by the purchase method, and that if true mergers were to be accounted for using a method other than the purchase method, the 'fresh start' method was likely to be more appropriate than the pooling of interests method" (BC48, d).

[1] These decisions are primarily applicable to single companies and not listed groups.

At this point, therefore, international convergence of accounting standards has been confronted with divergence rather than convergence. We argue that the Chinese standards setters have adopted a more transparent approach to accounting for business combination which recognizes that some combinations are mergers and not acquisitions. We believe that this acknowledgement is worthy of recognition by international accounting standards setting bodies (Baker, Biondi, and Zhang 2008).

The remainder of this paper is organized as follows. The first section discusses the cultural and economic context of accounting standards setting in China and provides an empirical example of a business combination under common control. The second section compares the theoretical basis underlying the IASB and CASC pronouncements dealing with business combinations. The third section discusses the arguments in favor of and against the pooling of interests method. The final section summarizes the main arguments of the paper in relation to the ongoing process of global accounting standards setting and accounting regulation.

2. ACCOUNTING FOR BUSINESS COMBINATIONS IN CHINA

2.1 Industrial reorganization in China

The rapid rate of economic development in China has prompted significant changes in accounting regulation (see Biondi and Zhang, 2007 for further details). These changes have been affected by: (i) reorganizations among state enterprises, (ii) expansion of private business activities, and (iii) a more welcoming attitude towards foreign investment and international business relationships (Xu and Uddin, 2008). Increasing economic development has also led to greater exposure by Chinese enterprises to foreign accounting practices and it has created a need for new accounting methods to account for modes of economic activity not previously encountered under state control (Suzuki et al. 2007). Among the issues addressed by the recent changes in accounting regulation are: accounting for consolidated entities, equity accounting, accounting for paid-in capital, fixed asset and depreciation accounting, intangible assets and goodwill, taxes and profit allocations. The case of business combinations is among these issues.

As was the case for many European countries before the adoption of IASB standards, the institutional structure of accounting regulation in China was primarily based on the legal and

political system. Accounting standards are established by the Ministry of Finance (MOF) pursuant to legislation adopted by the National People's Congress (Ezzamel et al. 2007). The China Accounting Standard Committee (CASC) was created to facilitate the standards setting process (Ernst & Young, 2006). Accounting regulation in China has been marked by two significant events. The first was the promulgation of a framework for accounting standards setting developed between 1988 and 1992 and summarized by the MOF in November 1992 under the title, "Accounting Standards for Business Enterprises" (Blake and Gao, 1995). The second was a set of revised accounting standards issued in February 2006 (Ezzamel et al., 2007).

As a prelude to the 2006 revised standards, in November 2005, the CASC and the IASB held a meeting in Beijing where a joint statement was issued by the Secretary-General of the CASC, Mr Wang Jun, and the Chairman of the IASB, Sir David Tweedie. This joint statement emphasized the specific needs of the Chinese context while nevertheless working towards convergence with IASB standards (IASB, 2005). The Chinese standard setters did not recognize the IASB as the Chinese accounting regulator. The direct application of IFRS by Chinese firms is explicitly forbidden (Deloitte IAS PLUS, 2008), as it is in Japan and Korea. Instead, the Chinese MOF established its own standards through a process of integrating and amending IASB standards. As a result, the institutional independence of the CASC was maintained. The Chinese authorities were particularly concerned about the impact of fair value accounting, as well as issues such as corporate governance, social responsibility, financial crises, and disruptions caused by globalisation (Biondi and Zhang, 2007; Xu and Uddin, 2008).

2.2 The Chinese standard on accounting for business combinations

CASC 20 was one of the standards included in the accounting reform of 2006 (see Ernst & Young 2006 for an English summary). CASC 20 standard sets forth the allowable methods of accounting for business combinations. It defines a business combination as "the bringing together of separate entities into one reporting entity". Two methods are permitted depending on the degree of common control:

- For business combinations involving entities under common control, the pooling of interests method must be applied;

- For business combinations involving entities not under common control, the purchase method must be applied.

In the first case, a business combination is recorded using the book values of the combining companies and no goodwill is recognized. In the second case, the business combination is accounted for based on the fair values of the net assets acquired, and goodwill is recognized, subject to impairment tests, but goodwill is not amortized.

The Accounting Department of the Chinese Ministry of Finance (AD MOF 2007, p. 292-293) provides the following definition of a business combination under common control: "The combining enterprises are ultimately controlled by the same party or parties before and after the combination, and control is not transitory". Some interpretive guidance was provided with this definition:

1. The party which can carry out the ultimate control over the combining enterprises before and after the combination is usually the mother company of an enterprise group;
2. The parties which can carry out the ultimate control over the combining enterprises before and after the combination are usually two, or more than two, legal persons or other organizations which demonstrate the same viewpoint or position when voting on the invested entities' productive and operational activities. In effecting the combination, these legal persons may intend to enlarge their voting shares in the invested enterprises, or strengthen the control status of certain investors over the invested enterprises, according to an existing agreement among investors;
3. The combining enterprises were controlled by the ultimate controller for more than one year before the date of combination, and the reporting entity after the combination will be controlled by the same ultimate controller for more than one year.

Thus, pursuant to the Chinese standard, business combinations are considered to be reorganizations among economic entities, rather than capital market transactions. The Chinese understanding of a business combination is therefore quite different from the understanding of business combinations contained in IASB standards. The Chinese understanding is relevant to the Chinese context, because many Chinese corporations are not listed in capital markets, and, even in the case of listed corporations, a large portion of their shares is not circulating or negotiable (Ding et al. 2005; Suzuki et al 2007). In 2007, of the

total shares issued by Chinese firms, the negotiable part accounted for 38.1%, on average (based on CSRC monthly report, http://www.csrc.gov.cn/). In addition, the Chinese approach to business combinations may be explained in part by an extensive amount of reorganization among state controlled enterprises, and other combinations under common control.

2.3 The reorganization of the TCL Group

State-owned enterprises in China are often controlled by a governmental agency (xingzheng zhuguan bumen), colloquially known as the 'mother company' (mu gongsi). "Each state-owned entity typically owes a subsidiary's duty of loyalty to a number of administrative units" (Ruskola 2000). The mother company may list its most profitable subsidiaries on the stock exchange, while continuing to be the controlling shareholder. Other less profitable subsidiaries may continue to be fully owned by the mother company. In 2004, state-owned or state-controlled enterprises accounted for 42.4% of the value-added by industry and 35.2% of the gross industrial output, while the private sector accounted for only 15.1% and 16.5%, respectively. Foreign owned enterprises (including those from Hong Kong, Macao and Taiwan) accounted for 27.8 and 31.4%.[3]

In 2003, TCL Group ("Parent") and TCL Communication Equipment Co. ("Subsidiary") entered into an agreement whereby the state-owned Parent merged with its publicly traded Subsidiary. The Subsidiary was the first component of TCL Group to be listed on Shenzhen Stock Exchange in 1993. Huizhou Investments, a government owned, limited-liability company, located in the city of Huizhou, Guangdong Province (southern China), was the majority shareholder of TCL Group. Huizou Investments was in turn controlled by the city of Huizhou, where TCL group is headquartered. Huizhou Investments is a government agency created to foster economic development in Guandong province. In 2003, TCL Group owned 106,656,000 non-circulating shares of TCL Communication Equipment Co., which represented 56.7% of the shareholders' equity of the Subsidiary. The other shares were traded on the Shenzen stock exchange. On 30 September 2003, TCL Group (the Parent) announced that it was going to combine with its Subsidiary through an exchange of shares. After the combination, the joint entity was listed on the Shenzhen Stock Exchange. The 81,452,800 circulating shares of the Subsidiary were exchanged for 404,395,944 shares of the Parent at an exchange price of 21.15 RMB, an exchange ratio of 4.965. The combination was completed on 7 January 2004 and the TCL Group was listed on 30 January 2004.

The pooling of interests method was used to account for the TCL Group reorganization. The press release issued to describe the transaction included the following reasons why the pooling of interests method was used. Firstly, all or most of the shares of the combining entities were exchanged. Second, the shareholders of the combining entities became the shareholders of the combined entity. Third, the shareholders of the combining entities collectively assumed all of the risks of the combined entity. Fourth, there were no resources flowing from the combining entities to other parties. Fifth, according to the projected exchange ratio, the equity owned by the controlling party (Huizhou Investments) did not change before and after the combination. For these reasons, the combination was better represented by the pooling of interests method.

In the annual report for 2003 (see Table 2), the consolidated net income of TCL Group was reported to be 570.57 million *RMB*, which included 145.18 million *RMB* of the net income of TCL Communication Equipment Co. (the Subsidiary) from January to June[2]. The shareholders' equity was 2,263.38 million *RMB*, so the return on equity (ROE) was 25.21% (see Table 2). If TCL Group had applied the purchase method, the performance ratios would have been reduced. At the date of the combination, the book value per share of TCL Communication Equipment Co. was 3.07 *RMB,* while the exchange price was 21.15 *RMB*. Thus, the 'computed goodwill'[3] would have been 1,473 million *RMB* based on combining only the circulating shares without recognizing any control premium. This goodwill would have added 1,473 million *RMB* to the shareholders' equity. If the purchase method had been used, the net income of the Subsidiary before the combination date would not be recognized in the consolidated income statement, and the goodwill produced by the combination would not be amortized. As a result, the net income of TCL Group would be reduced by 145.18 million *RMB*, from 570.57 million *RMB* to 425.39 million *RMB*, while the shareholders' equity would be increased from 2,263.38 million *RMB* to 3,736.38 million *RMB*. Therefore, the return on equity (ROE) would be reduced from 25.21% to 11.39%.[4]

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[2] The record date for recognition of the business combination was 30 June 2003, even though the combination was effected several months later.

[3] The calculation of the 'computed goodwill' is as follows: (21.15-3.07) × 81452800 = 1,472.67 million *RMB*. Because of the limited disclosure of data, the fair values of TCL Communication Equipment Co. cannot be utilized; this is why the 'computed goodwill' is used here instead of the actual goodwill.

[4] The above calculation of the 'computed goodwill' takes into account only the circulating part of the shares. If the TCL Group (the parent) did not hold the original 56.7% shares of TCL Communication Equipment Co (the Subsidiary), and if all the shares of TCL Communication Equipment Co. were combined at the same exchange ratio, the 'computed goodwill' would be of 3,401 million RMB. In that case, the net income of TCL Group in

***** Insert Table 1 here *****

If the purchase method had been applied to the TCL Group there would have been a significant negative impact on the consolidated financial statements of the Group. The managers may not have proceeded with the combination, notwithstanding the important industrial and productive reasons for undertaking the combination. In addition, the negative effects on the performance ratios might have modified the initial public offering price of TCL Group shares, and this could affect the share price. Finally, the solvency ratio would have changed significantly (from 4.51 to 2.73) as a result of an increase in shareholders' equity, even though the liabilities of the Group would not change. Pursuant to the pooling of interest method, goodwill was not recognized; therefore, all these performance ratios did not deviate substantially from those of prior years, thereby more properly representing the underlying economics of the business combination.

In summary, the underlying economics of business combinations in China involve a transfer of assets "from one pocket to another pocket" (Pan 2002). The terms and conditions of business combinations are determined by the controlling parties, and ownership control is not actually transferred. The underlying economics of this type of business combination are more properly represented by the pooling of interest approach. Huang et al. (2004) also point out that many Chinese business combinations occur among related entities. In this context, the use of the pooling of interests method is not only sound from an accounting standpoint, it also reduces transaction costs. Thus, in a setting where the capital markets are less than perfect and "fair values" are not reliable, the pooling of interests method is the most appropriate method of accounting for business combinations.

3. THEORETICAL DISCUSSION AND ANALYSIS

The International Accounting Standards Board (IASB) was created in 2001 for the purpose of achieving convergence of financial accounting standards on a worldwide basis. The pronouncements of the IASB have been introducing a new accounting framework based largely on fair value basis of accounting, which in many respects is radically different from

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2003 would be still 425.39 million RMB, but the equity would be raised from 2,263.38 million RMB to 5,664.38 million RMB; thus, the return on net assets would be reduced from 25.21% to 7.51%.

the historical cost approach derived from normative accounting theory. In the case of accounting for business combinations, the IASB has taken the position that virtually all business combinations are acquisitions (IFRS3, BC48, c) and that the purchase price of an acquired company represents the best measure of the fair value of the assets and liabilities of the acquired company, including acquisition goodwill (IFRS3, 24, a). By issuing Statement No. 20, which rejected the idea that all business combinations are acquisitions, the CASC focused on the reorganization of combining economic entities. Thus, there are significant theoretical differences between the approach taken by the IASB and the CASC.

The TLC case has provided an empirical example of the different understandings of the underlying economics business combinations held by the IASB and the CASC. In order examine these different understandings more thoroughly, this section presents a comparative analysis of the provisions of IFRS 3 and CASC 20. The key provisions of the two pronouncements are summarized in Table 3. The table is divided into the following categories: (*i*) definition of a business combination; (*ii*) exclusions from the scope of the standard; (*iii*) key concept for application; (*iv*) treatment for acquisition goodwill; (*v*) valuation of identifiable assets, liabilities and contingent liabilities; and (vi) the accounting method of reference.

*****Insert Table 2*****

The IASB views a business combination as an acquisition in which the consideration exchanged is based on arm's length bargaining between unrelated parties. This leads to any purchase premium (i.e. goodwill) being treated as a permanent intangible asset that is recognized and not amortized but periodically tested for impairment. While the CASC recognizes the possibility of this type of business combination and allows for the acquisition method to account for such combinations, the CASC also recognizes the existence of another type of business combination (i.e. merger) in which there is not an arm's length bargaining between unrelated parties. In this case, there should be no revaluation of assets and liabilities and no recognition of goodwill.

Following the FASB approach, the IASB essentially based IFRS 3 on the concept of a change of control. IFRS 3 (11, 39 and Appendix A) defines control as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". The IASB alluded to the possible existence of other types of business combinations, such as those where there is no change of control, or a combination between a parent and subsidiary, or combinations among entities under common control. However, these types of business combinations were excluded from the scope of IFRS 3. The difficulty with mandating a single method of accounting in a global context is that the prescribed method may not encompass all possible transactions. It is reasonably clear that acquisition accounting should be used for virtually all transactions defined as a "business combination", whilst pooling accounting method is definitely excluded from accounting for them.

Pursuant to the revision of IFRS 3 issued in January 2008, the acquiring company is permitted to measure any noncontrolling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets (paragraph 19). This permission to measure any noncontrolling interest at the proportionate share of the acquiree's net assets approximates the pooling of interest method in a less informative way. Thus, the pooling of interests method, which was eliminated by previous standards, appears to have been re-introduced in somewhat altered form (Baker, Biondi and Zhang 2008). This back-door reintroduction of pooling reinforces the asymmetry between acquisitions where there is a *change* of control, and other acquisitions where there is no change of control.

The IASB reached the conclusion that all business combinations are acquisitions where control of one of the combining entities changes hands. However, it is often difficult to determine whether a change of control has taken place. A number of business practices exist which permit a change of control without achieving ownership. Furthermore, "a business combination may be structured in a variety of ways for legal, taxation or other reasons" (IFRS 3, §5), even apart from an acquisition of ownership control. Consequently, making a distinction between accounting methods based on a criterion of a change in ownership control may be contradicted by actual business practices. .

The IASB understanding of the underlying economics of business combinations was based on acquisition model that envisions a capital market transaction among unrelated parties at a fair market price. The Chinese standards setters have suggested an alternative approach based on the notion of "common control" instead of a "change of ownership control". Pursuant to the Chinese perspective, the underlying economics of many business combinations reflects a continuity of business interests and activities. This continuity of business activities may involve a change in strategies, organizational structures, shareholding interests, or management, but its primary purpose is the enhancement of the ongoing activities of the combining entities. Many business combinations - in China and elsewhere - are reorganizations among related entities, rather than capital market transactions. According to Jackson and Miyajima (2007), in 1991-2005, only a small minority of the business combinations in leading economies concerned publicly listed target companies (7,8% in Germany, 14,9% in USA, 9,5% in UK, 23,3% in Japan, 14,4% in France), and this proportion was decreasing, whilst one half were private companies (including in the USA and UK) and one third were subsidiaries (including in USA and UK). According to these statistics, based on the Thomson Deals database, at least one third of the combinations are intra-group reorganizations, whilst one half occurs in a private setting where the representational focus on an (efficient) capital market transaction scarcely applies. Drawing upon this preliminary evidence, "common control" may in fact be the main feature of business combinations rather than the exception, because continuity in the underlying financial and operating activities is expected to occur. Control is therefore a matter of continued "coordination" rather than a change of "ownership control".

By issuing Statement No. 20, the CASC did not focus on the representation of a business combination as an acquisition taking place in a capital market transaction. Rather the focus was on the reorganization of economic activities. This perspective is consistent with the entity theory of accounting. While the IASB began with the entity theory, it quickly moved to an acquirer's perspective (i.e. proprietorship theory), which views a business combination as a takeover of a target company by an acquiring company through an acquisition of ownership control[5]. A proprietorship perspective reflects the viewpoint of the shareholders of the acquiring company who want to have information about the values of the accounting

[5] According to the revised release of IFRS3, including a not fair value measurement at least in some cases, the IASB's position on the matter is perhaps more prudent, but it is not yet fully disclosed and applicable, so any conclusion is provisional.

elements of the disbanded target entity, including previously unrecognized goodwill. However, for this information to be relevant and reliable, the fair values of the net assets of the target company, as well as the total consideration paid, must be "fair," i.e., the whole process must take place in complete and efficient markets. This is not the case if the parties to the combination are related or are under common control.

Furthermore, it should be noted that the shareholders of the acquiring entity do not actually acquire the assets or the shares of the target company. The underlying economics of a business combination do not involve an "acquisition" but rather a "combining" of previously separate entities. A business combination is therefore a matter of operational continuity rather than a change of ownership control. Operational control involves a coordination of operations and activities among ongoing entities. If the combining entities are related to each other, and they share their business activities in some way, then the pooling of interests approach may be more appropriate. Consequently, the CASC took a distinctly different view of the underlying economics of business combinations, one which was based on an entity perspective of the ongoing operations of the combining entities.

In an economic system characterized by competing business entities, a business combination may be best understood as reorganization between entities whose "governing" parties want to combine their activities in order to pursue them in an enhanced way. This image does not correspond with the acquisition method. Many business combinations occur in a relational economic context among business entities, and those combinations do not reflect an arm's length bargaining in a competitive marketplace. When combinations occur among related entities, the posted prices do not reflect the underlying economics of the combination process. In such cases the use of the acquisition method leads to recognition of internally generated goodwill and the capitalization of uncertain future benefits, as well as a failure to match the amortization of recorded goodwill against future revenues. According to Busse von Colbe (2004, p. 212), the recognition of the discounted present value of uncertain future benefits may lead to unrealized profits being distributed as dividends. In addition, this recognition can lead to a confused tax basis. In a combination among related economic entities, it is highly unlikely that the recognized goodwill or the "fair value" of the net assets of the combined entity will fairly represent the values implied by the underlying economics. If the pooling of

interests method were used instead, the net assets of the combining entities would be accounted for using book values, and the problem of unfair "fair values" would be avoided.

4. DISCUSSION AND IMPLICATIONS

The arguments advanced by the IASB in favor of the acquisition method are questionable when considered in light of the Chinese pronouncement on accounting for business combinations. Effectively, the IASB ignored the existence of mergers and focused instead on acquisitions, even though both mergers and acquisitions exist in empirical economic settings. Respondents to the IASB exposure drafts argued that mergers should be accounted for differently from acquisitions[6]. According to Ramanna (2007, p. 49), a majority of firms commenting on FASB 141 were in favour or maintaining the pooling of interests method. As well as paragraph B41 of FASB 141, paragraph BC34 of IFRS3r even noted that when undertaking a business combination, shares could be issued for cash and then the cash could be used to effect the combination, with the end result being the same as if shares had been used to effect the combination. However, when cash is used, the acquirer's shareholders provide the cash, and the shareholders of the target company are liquidated. When a combination is effected through an exchange of shares, the acquiring company's shareholders do not provide cash; rather, the shareholders of the target become the shareholders of the combined entity. Consequently, the two types of transactions are not the same, either in their underlying economics or their results.

With respect to the discontinuity that is assumed to take place in the acquisition method, there often is frequently a continuity of interests in a merger. All business combinations entail some bringing together of commercial strategies. This observation is at odds with the assumed discontinuity of the acquisition method. Furthermore, the prohibition of the pooling of interest or merger method may not be sound in an empirical sense because it is clearly possible to identify business combinations that are not acquisitions. If the existence of different kinds of business combinations is possible, the reliance on a single method is not justifiable. When certain economic features of a transaction distinguish them from other transactions, then it is appropriate to account them in different ways. If the existence of different types of business combinations is nowadays conceded by all the participants in the

[6] See for example, the minority dissenting opinions of Geoffrey Whittington and Tatsumi Yamada to IFRS 3 (IFRS 3, DO1-DO16).

accounting arena, accounting regulation, *especially if based on principles*, may easily accept to leave preparers choose, and concentrate then on careful guidance that shall avoid opportunistic switch among methods through time. Furthermore, a choice among methods is preferable if the intentions of management with respect to the underlying transactions are different. By choosing among alternatives, managers present signals to investors and analysts, thus providing qualitative information about strategies and policies adopted.

Last but not least, the provision of information about intangibles that is assumed with the acquisition method may be questionable. When a business combination is effected through an exchange of equity interests, or without any transfer of consideration, it is questionable whether anything of economic substance has occurred. Moreover, according to some empirical studies, the lack of recognition of acquisition goodwill does not impact value relevance in capital markets. Hopkins et al. (2000) present evidence suggesting that analysts assign a lower post-acquisition value to a purchase combination in which the parent company records and amortizes an acquisition premium (i.e. goodwill), compared with either a purchase combination in which the parent expenses the entire premium as in-process research and development, or a pooling-of-interest combination. Their findings looked at analysts' share-price judgments regarding combinations occurring three years in the past as compared to one year in the past. The pooling approach may therefore be preferred, even by capital markets.[7] Furthermore, Mintchik (2006) has attempted to disentangle the impact on earnings forecast errors by eliminating pooling from accounting for goodwill and other disclosures. She provides evidence that the existence of pooling does not create additional problems for accurate forecasting and that the improved disclosure is beneficial.

In sum, the rationale for eliminating the pooling of interests method is questionable. The primary argument in favor of the acquisition method is that virtually all business combinations are acquisitions. This ignores the existence of mergers, which are not acquisitions, but rather, reorganizations of economic activities. Business combinations are complex and significant events which need to be accounted for carefully. This complexity

[7] Pursuant to efficient market theory, market prices are the best representation of value, and accounting must follow them. However, the accounting information received by the capital markets is based on the earnings of the firm mainly generated through time and hazard (Biondi, 2005). This information plays an important role by providing a common knowledge base available for subjective valuation and decision-making (Sunder, 2001). This is a particular type of information that complements and does not follow the information provided by the price system (Biondi, 2003; Biondi and Rebérioux, 2008).

should lead to the search for the distinctive features of business combinations which discriminate between different types of transactions under conventional or featuring bases.

The elimination of pooling appears to have been motivated by a different and perhaps limited understanding of this method. The typical view has been to consider pooling from the proprietorship perspective, viewing the combination as an exchange transaction between the owners of the combining entities. This accounting representation has merit when the combination is effected solely through an exchange of ownership interests, and it may be understood to be a mere change in legal form. But, when a significant change in ownership interests is involved, something of economic substance has occurred, especially when the entity is required to expense the issuance of the shares distributed to effect the combination, and a significant premium is paid in the exchange ratio. In order to recognize this economic event, the acquisition method was defined to be the solution that allowed accounting for business combinations independently from the means utilized to effect the combination. This decision was motivated from a capital market perspective which conflates the consideration paid with a change in ownership control. However, from the Chinese viewpoint, which focuses on the merger of ongoing business entities, the main point is the distinction between shareholders' equity and entity equity (Biondi, 2007). If we make a distinction between shareholders' equity and entity equity, the "mere change in legal form" argument no longer holds, and continuity of operations becomes the cornerstone of the pooling approach. From this perspective, the non recognition of acquisition goodwill allows for the maximum consistency in accounting reports (and related measures of performance). At the same time, this continuity of operations perspective may actually constitute a coherent basis for recognizing goodwill.[8] The pooling method can distinguish entity equity from shareholder equity, and thus recognize the difference between the consideration paid and the net book value of the acquired firm as a variant of "acquisition goodwill" which does not require estimating fair values of specific assets. The acquiree's shareholders are effectively receiving consideration in exchange for ratifying the merger, especially when the business combination takes place among entities not under common control. By making a distinction between shareholders' equity and entity equity, the pooling approach can charge or credit the acquisition differential to entity equity. This would then account for the implicit financial

[8] Many respondents agreed that, if goodwill is also capitalised, it should be amortised, to make management responsible of the investment of entity resources that might be utilised otherwise, or distributed to stakeholders.

resources management is using to effect the merger (instead of utilizing these resources otherwise, in reinvestments, dividends or donations).

5. CONCLUSION

Accounting for a business combination using the acquisition method requires the identification of an acquiring entity, the identification of an acquired entity, and the measurement of an acquisition price. While this is seemingly a straight forward exercise, the satisfaction of these requirements underestimates the complexity associated with the synergistic transformation that takes place in a business combination. The measurement of the acquisition price requires an undue reliance on the consideration paid as the proper measure of value, and it forces an unreliable estimation of fair values as the basis for future accountability (Ramanna and Watts 2007). The inclusion of minority interests in the overall equity continues the "change of ownership" concept adopted by the IASB and emphasizes the assumed existence of "diffuse ownership" in competitive capital markets (Holderness, 2008). As a result, it is practically impossible to distinguish fair value from book value. Moreover, transactions between shareholders and the acquiring company may be accounted for as equity transactions. This presents a problem that is similar to the one that stigmatized pooling in the first place: if the transaction has a cost for the entity (i.e., involves a payment to minority shareholders from entity resources), the payment is not recognized or accounted for.

These difficulties raise significant questions about the acquisition method. The alleged congruence of the acquisition method with the historical cost principle (IFRS3r, BC41) is based on an analogy between a business combination and a purchase of a single asset. This analogy is driven by the image of a transfer of ownership control, where the right to exercise control is paid for in a lump sum, but from an accounting perspective, the net assets are actually combined on a piecemeal basis. Consequently, the representation of the underlying economics of a business combination as reflected by the acquisition method is at odds with the idea of the firm as an economic entity and a going concern. Continuity in the operations of the entity is a primary requisite for a going concern. Continuity also becomes a useful criterion for distinguishing between a merger (continuity) and an acquisition (lack of continuity). When a business combination takes place between entities under common control, continuity of operations is obvious because the enterprises are related components of

the same economic entity. When the combination occurs among economically independent entities, the continuity of the enterprises depends largely on management's strategic intentions; nevertheless, continuity is often the desired strategic objective.

The economic entity assumption and the going concern assumption are central concepts to accounting theory which have been adopted in virtually every country and regulatory context (Hoarau, 2006, p. 43).[9] These assumptions provide the basis for historical cost accounting, but historical cost accounting does not purport to provide a current valuation for the firm; instead it reflects the income generating processes of the firm over time. The acquisition method is therefore not consistent with historical cost accounting. Moreover, when the complexities of the underlying economics of a business combination are accounted for using the acquistion method, the reported values are only estimates. There is a disregard of the continuity in the activities of the combined enterprises. This casts doubt upon the relevance of fair values which are subjectively estimated, either for assessing managerial accountability or for purposes of share valuation.

If some transaction are felt to be too complex to be properly accounted for, accounting regulation might just as well be reduced to providing general guidance and allow managers to make choices regarding specific accounting methods. If opportunistic behaviors and misleading representations are feared to be the result of accounting flexibility, then it may be more prudent to allow only one method; but in that case it might well be that the pooling of interests method would be preferable in most cases. The elimination of the pooling method seems to have been based on a particular understanding of the underlying economics of business combinations. The Chinese accounting standards setters ought to develop a distinctly different understanding of business combinations, one which reflects the possibility that there will be reorganizations among entities under common control and that these types of combinations should be accounted for using the pooling of interest method.

[9] Cf. also FASB 141, paragraphs B53 et B54.

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TABLE 1

Pro Forma Analysis of the Impact of
Pooling versus Purchase for TCL Industries Reorganization
(Million RMB)

	Pooling Method (as reported)	**Purchase Method (pro forma)**
Consolidated net income (a)	570.57	425.39
Total Liabilities (b)	10,199.94	10,199.94
Shareholders' equity (c)	2,263.38	3,736.38
Acquisition goodwill	--	1,473.00
Return on Equity (a/c)	25.21%	11.39%
Debt to Equity (b/c)	451%	273%

TABLE 2
Comparison of IFRS 3 and CASC 20

	IFRS 3	**CASC 20**
(i) Definition of a business combination	A business combination involves the bringing together of separate entities or businesses into one reporting entity.	A business combination involves the bringing together of separate entities or businesses into one reporting entity.
(ii) Scope exclusions	♦ Joint ventures ♦ Entities under common control ♦ Mutual entities ♦ Combinations by contract alone without obtaining ownership interest	♦ Long-term equity investments
(iii) Whose controls	Acquirer	Controlling party or parties
(iv) Treatment of goodwill	Recognized as an asset, but not amortized. Tested for impairment.	♦ *Entities under common control*: not recognized. ♦ *Entities not under common control*: Recognized as asset, but not amortized. Tested for impairment.
(v) Valuation of assets and liabilities	Fair value	♦ *Entities under common control*: Book value. ♦ *Entities not under common control*: Fair value.
(vi) Accounting method of reference	Purchase	♦ *Entities under common control*: Pooling. ♦ *Entities not under common control*: Purchase